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MAC/MAE clauses and the COVID-19 pandemic: a checklist of things to consider

27 March 2020

The novel coronavirus (COVID-19) has been declared a global pandemic by the World Health Organization (WHO). The virus has spread across continents, taken an enormous human toll, and disrupted business operations throughout the United States and the world. Given the operational risk to businesses, buyers and sellers in merger and acquisition transactions may be considering whether to proceed with an acquisition during this uncertain time.

A material adverse change or material adverse effect (MAC/MAE) clause in a merger agreement may permit a party to terminate its obligations.[1] However, the determination of whether a MAC/MAE has occurred is fact-specific and contract-sensitive. The inquiry does not lend itself to resolution through simple "quantitative considerations."[2] Whether a MAC/MAE has occurred is analyzed in the "context in which the parties were transacting."[3]

If cancellation of a merger on the basis of a MAC/MAE is being considered, the following factors should be considered, as they are factors a court will likely consider when determining whether a MAC/MAE provision applies.

1. **How does the contract define a "Material Adverse Change" or "Material Adverse Effect"?**

    - The scope of events potentially covered by a MAC/MAE clause can affect its applicability. If a MAC/MAE clause excludes pandemics or other international health crises as a market risk to be borne by the buyer, it could potentially prohibit the buyer from invoking the clause.

    - For example, a MAC/MAE clause in a recent case excluded "*pandemics*, earthquakes, floods, hurricanes, tornados or other natural disasters" along with other events from forming the basis of a MAC/MAE. This type of exclusion could undermine an argument that a seller experienced a MAC/MAE due to the COVID-19 pandemic, and that the buyer's obligation to close should be excused.

2. **Business Risk vs. Systematic Risk**

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[1] Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347, at *47 (Del. Ch. Oct. 1, 2018).
[2] Channel Medsystems, Inc. v. Bos. Sci. Corp., No. 2018-0673-AGB, 2019 WL 6896462, at *34 (Del. Ch. Dec. 18, 2019).
[3] Hexion Specialty Chemicals, Inc. v. Huntsman Corp., 965 A.2d 715, 738 (Del. Ch. 2008).

- MAC/MAE provisions often distinguish between "market" risk and "business" risk. This distinction generally "allocates general market or industry risk to the buyer, and company-specific risks to the seller."[4]
    - Market risk may be interpreted as "beyond the control of all parties and . . . will generally affect firms beyond the parties to the transaction."[5]
    - Business risk may be interpreted as arising "from the ordinary operations of the party's business . . . and over such risks the party itself usually has significant control."[6]
- The COVID-19 pandemic may be determined to be an example of a market (or "systematic") risk. If an agreement allocates market risk, including a global pandemic, to the buyer, sellers may argue that such a risk is not covered by the MAC/MAE clause of the contract. In other words, the seller's argument would be that the COVID-19 pandemic did not cause a MAC/MAE under the terms of the contract. As discussed below, the specific terms of the agreement will control.

3. Alternative reasons for the seller's condition

- Delaware Court of Chancery recently commented on "buyers who agreed to acquisitions, only to have second thoughts after cyclical trends or industrywide effects negatively impacted their own businesses, and who then filed litigation in an effort to escape their agreements."[7]
- Courts may be disinclined to apply MAC/MAE provisions in a contract if the seller's diminished condition is attributable to causes other than the claimed adverse event. A typical example of an alternative cause is seasonal cyclicality that affects businesses as a whole.

4. What was known at the time of contracting?

- A party's knowledge of an alleged material adverse event at the time of contracting may affect whether performance is excused. The details of how and when the seller's business became affected by the event or condition, and when such impacts became known, will bear upon a court's analysis of whether a MAC/MAE event has occurred.

5. Long-term implications of the MAC/MAE

- Courts are reluctant to allow buyers to abandon their obligations to close a deal if the effect of the alleged MAC/MAE is short-lived. This is because mergers and acquisitions are considered part of the buyer's "long-term strategy."[8] While there is no objective time period within which the MAC/MAE's long-term implications are analyzed, it has been described as being "measured in years rather than months."[9]
- Parties should consider the short-term and potential long-term effects of the COVID-19 pandemic. Courts will take a very fact-specific view of the circumstances. A seller will need

[4] Id. at *49.
[5] Id. at *50.
[6] Id.
[7] Id. at *3.
[8] In re IBP, Inc. Shareholders Litigation v. Tyson Foods, Inc., 789 A.2d 14, 67 (2001).
[9] Id.

to show that its recent earnings downturn was a "short-term hiccup,"[10] whereas a buyer will need to show that such an earnings issue is evidence of a sustained downturn.

6. Expert support

- Expert support for a party's position can be important in assessing a MAC/MAE claim.[11] Investment banks, accounting firms, and other financial institutions are well-positioned to lend industry credibility to a claim that a seller was or was not materially affected by the COVID-19 outbreak.

7. Burden of proof

- Courts generally are hesitant to apply MAC/MAE clauses. And "absent clear language to the contrary, the burden of proof with respect to a material adverse effect rests on the party seeking to excuse its performance under the contract."[12]

[10] Id. at *68.
[11] Id. at 70 (lack of expert support for buyer's contention that seller suffered material adverse effect was "significant").
[12] Hexion, 965 A.2d at 739 (Del. Ch. 2008).

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